Internal Revenue Service
memorandum

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to: Case Manager, Group 1110
Houston District Stop 4110HOU

from: Senior Technician Reviewer, Branch 4
CC:FI&P:04 Donald J. Drees Jr.

subject: Adjustments to insurance companies' shareholders surplus accounts under section 815 of the Internal Revenue Code in a life/life consolidated return TR 45-906-91

Your memorandum requests assistance under section 815 of the Internal Revenue Code for the proper determination of additions to and subtractions from the shareholders surplus account ("SSA") of life insurance companies in an affiliated group consisting only of life insurance companies ("life/life group") which file a consolidated return. In addressing this issue, we have assumed that each member in the life/life group is a domestic corporation, meets the requirements of a life insurance company under section 816 and has an existing SSA under section 815(c) and an existing policyholders surplus account ("PSA") under section 815(e).

The provisions for SSA and PSA currently in effect pursuant to the Deficit Reduction Act of 1984 ("The 1984 Act"), Pub. L. No. 98-369, section 211, et. seq., 98 Stat. 494 (1984), originally derived from the prior law as contained in the Life Insurance Company Income Tax Act of 1959, ("The 1959 Act"), Pub. L. No. 86-69, 73 Stat. 112 (1959). Under the 1959 Act, life insurance companies were taxed under a three phase system. Former section[1] 802(b) of the Code provided that the life insurance company was taxed on the lesser of its taxable investment income[2] or gain from operations[3]; this amount was Phase I income. If gain from operations exceeded taxable investment income, the company was also taxed on one-half of the excess of gain from operations over taxable investment income; this was considered Phase II income. The remaining one-half of the excess of gain from operations over taxable investment income which was not included in Phase II income was not currently taxed

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[1] "Former section" describes the law prior to the 1984 Act.

[2] Taxable investment income was described in former section 804(a)(2) of the Code.

[3] The gain or loss from operations was defined in former section 809 of the Code.

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and was added to the PSA, a tax deferred account.

The amounts credited to the PSA were subject to tax only when distributed to shareholders. The distribution was taxed to the company under former section 802(b)(3) and was considered Phase III income. The combination of Phases I, II and III incomes constituted life insurance company taxable income, LICTI.

The SSA represented items of income that were previously taxed or nontaxable and were available for distribution to shareholders. Annual additions were made to the SSA equal to the sum of LICTI (computed without regard to any distribution from the PSA), net capital gains reduced by LICTI (computed without regard to PSA distribution), tax-exempt interest, dividends-received deduction, small business deduction and prior year transfers from PSA less the taxes imposed.[4] At such time as distributions were made from the SSA, there was no tax to the company.

The PSA represented items of income that had not yet been taxed but were taxable. The annual addition to the PSA was the sum of one-half of the excess of gain from operations over taxable investment income, the deduction for certain nonparticipating contracts and the deduction for accident and health insurance and group life insurance.[5] The amounts reserved in the PSA were not taxed at the time they were earned by the company or allocated to the PSA, but rather taxation was deferred until distribution to the shareholders. By directing the timing of its distributions from the PSA, the company controlled the timing of taxation on Phase III income.

The changes made by the 1984 Act with respect to taxation of life insurance companies essentially eliminated the phase system of taxation, but continued existing PSAs and SSAs. Section 815(d)(2) of the Code indicates that after December 31, 1983, there are no additions to the PSA; however, under section 815(c)(2), there are continuing annual additions to the SSA. The undistributed amounts credited to the existing PSA as of December 31, 1983, will only be taxed under section 815(a)(2) at such time as they are distributed.

A stock insurance company distributing funds to its shareholders must subtract amounts from the SSA and PSA under the 1984 Act. Sections 815(c)(3) and (d)(3) of the Code. The amounts are subtracted pursuant to the ordering rule of section 815(b) of the Code, such that distributions to shareholders shall be treated as made first out of the SSA and then out of the PSA

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[4] Former section 815(b)(2).

[5] Former section 815(c)(2).

and finally, out of other accounts. A company can determine its tax liability with respect to PSA distributions by limiting its annual shareholder distributions to the amounts credited to the SSA.

Under the 1984 Act, the annual addition to the SSA is the sum of LICTI[6] (but not below zero), the small life insurance company deduction provided by section 806 of the Code, the special life insurance company deduction[7], the deductions for dividends received (as modified by section 805(a)(4)) ("DRD") and the amount of interest excluded from gross income under section 103 ("tax-exempt interest"). Taxes imposed by section 801 (determined without regard to taxes imposed by section 815) are deducted from the annual additions to the SSA. As in prior law, amounts added to the SSA represent positive items which have either already been subject to tax or are nontaxable and which are available for distribution without additional tax. See, Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 595 (Comm. Print No. 41) (1984) (hereinafter 1984 Blue Book).

Your inquiry concerns the additions to and subtractions from the SSA of the life members in a life/life group which files a consolidated return.[8] Additions to the SSA are dependent, in part, on the consolidated taxable income of the life/life group. In determining consolidated taxable income of corporations other than insurance companies, section 1503 of the Code and section 1.1502 of the Income Tax Regulations state that certain items of income and deduction are computed for each company on a separate basis and certain items are computed on a consolidated basis. Those items which are consolidated include net operating loss (NOL), capital gain, section 1231 net loss, charitable contributions deduction, section 922 deduction, dividends

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[6] LICTI is defined in section 801(b) of the Code and does not include distributions from the PSA.

[7] The special deduction was repealed in Tax Reform Act of 1986, Pub. Law. No. 99-514, §1011(b)(10), 100 Stat. 2085 (1986) for tax years beginning after December 31, 1986. While it was in existence, it was afforded SSA treatment similar to that of the small life insurance company deduction.

[8] The issue raised in this memoranda was the subject of three private letter rulings, numbers 7809020, 7813085 and 7918106. The conclusions reached in these rulings applied the 1959 Act to life/life groups and substantially determined the same result as presented herein.

received deduction and section 247 deduction.[9] Each member computes separate taxable income with the exclusion of the consolidated items. The separate taxable incomes of the members are added to the consolidated items to equal consolidated taxable income.

Section 1.1502-47 of the regulations addresses consolidated returns involving life insurance companies and nonlife insurance companies "life/nonlife group".[10] For a life/nonlife group, pursuant to section 1.1502-47(a)(2), the determination of consolidated taxable income requires that the nonlife members (the nonlife subgroup) compute nonlife subgroup consolidated taxable income and the life members (the life subgroup) compute consolidated partial LICTI.[11] The life subgroup losses, consisting of consolidated loss from operations and life consolidated net capital loss, can be used to offset nonlife subgroup consolidated income. The nonlife subgroup losses, consisting of nonlife consolidated net operating loss and nonlife consolidated net capital gain, may be used to offset life subgroup partial LICTI. Once the income and losses of the subgroups have been adjusted, the amount of any PSA distributions is added to the adjusted sum to total the consolidated taxable income. The PSA distributions are fully taxed and may not be offset by any losses of the life or nonlife groups.

Consolidated returns for life/life companies are authorized by section 1504(c)(1) of the Code. There currently are not any regulations specifically relating to life/life consolidated returns. A life/life consolidated return should reflect the general policies outlined in the regular consolidated return regulations, to the extent that these are not inconsistent with the application of the Code for insurance companies. Additionally, the rules set out in the life/nonlife regulations may provide guidance in the proper filing of a life/life consolidated return and the calculation of the addition to the SSA for the members filing such a return.

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[9] The regulations at section 1.1502-11, <u>et seq.</u> contain specific details on the computation of each of the consolidated items.

[10] The regulations were promulgated prior to the enactment of the 1984 Act and do not reflect the substantive changes in life insurance law created by that statute.

[11] The term consolidated partial LICTI as employed in the regulations refers to the law in effect prior to 1984 and was defined in section 1.1502-47(d)(3) of the regulations as consolidated LICTI without section 802(b)(3) income. Section 802(b)(3) income, as defined in the 1959 Act, was the amount distributed from the PSA for the taxable year.

The life/life return should provide for a consolidated tax and consolidated taxable income based on the provisions of sections 1.1502-2 and 1.1502-11 of the regulations. See also sections 1.1502-47(f)(7) and 1.1502-47(g). Consolidated taxable income of the life/life group should be identified as "consolidated LICTI" and it should be determined pursuant to the general principles of computation for a consolidated return. The sum of consolidated LICTI and the distributions from the PSA result in consolidated total income subject to tax pursuant to sections 801 and 815 of the Code.[12]

While neither sections 815(c) nor 1504(c)(1) of the Code specifies whether there is one SSA and one PSA for the life/life group (or life subgroup in a life/nonlife group) or separate SSAs and PSAs for each life member in the group, in analyzing the issue, it is apparent that each life member should maintain separate accounts. Additionally, the life/nonlife regulations, at section 1.1502-47(g)(3), specifically refer to multiple PSAs in defining consolidated taxable income by including "the sum of the amounts subtracted under section 815 from the policyholders' surplus accounts of the life members" (emphasis added).

Subtractions from the SSA occur when the company with the SSA makes a distribution to shareholders pursuant to section 815(c)(3) of the Code. These subtractions are made by each company from its own SSA and are not affected by the filing of a consolidated return.

Section 815(c)(2) of the Code states the items that must be included in the annual addition to the SSAs of each life member with an existing PSA. The annual addition to the SSAs is based on the sum of consolidated LICTI (but not below zero), the small life insurance company deduction, the special life insurance deduction, the DRD and the amount of tax-exempt interest less the amount of taxes imposed for the year by section 801 (determined without regard to section 815). Each of these items must be allocated among the SSAs of the life members.

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[12] Under current law, LICTI is defined in section 801(b) and does not include PSA distributions. Section 801(c) indicates that PSA distributions are taxed under section 815. Section 815(a) imposes tax on LICTI and imposes tax on distributions from the PSA. For the purposes herein, the term "consolidated LICTI" is defined as the amount taxable in section 815(a)(1) as the LICTIs of the life members consolidated pursuant to section 1.1502 of the regulations and the term "consolidated total income" refers to the consolidated LICTI plus the total PSA distributions from all life members.

Small Life Insurance Company and
Special Life Insurance Company Deductions

Section 806(c) of the Code specifies the consolidated return treatment of the small life insurance company and special life insurance company deductions (hereinafter "small and special deductions"). All life insurance companies which are members of the same controlled group are treated as one life insurance company for purposes of determining the amount of the deductions. The amount of the total deductions are then allocated among the life members in proportion to their respective tentative LICTIs. Tentative LICTI is defined in section 806(b)(1) as life insurance company taxable income determined without regard to the small or special deductions.

The small and special deductions were enacted in the 1984 Act. The legislative history indicates that the intent was to allocate the small and special deductions proportionately among those life members having positive tentative LICTI. 1 Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, at 532, 534 (S. Comm. Print No. 169) (1984); See also, 1984 Blue Book at 591, 593.

The allocation of the special and small deductions to the SSAs in proportion to the separate positive tentative LICTIs is a means of crediting each company with an addition to its SSA which bears a direct relationship to the amount of positive LICTI earned by that company. The small and special deductions are derived from the amount of positive LICTI and the allocation to the SSAs based on the separate positive LICTIs connects the item added to the SSA and its source. Thus, between two companies, the company with the greater positive tentative LICTI is allocated a greater portion of the small and special deductions and accordingly, a greater addition to that company's SSA.

Life Insurance Company Taxable Income

Consolidated LICTI should be allocated among the SSAs of the life members in proportion to the amount of positive LICTI of each member. This is similar to the allocation statutorily required for the small and special deductions. Since the consolidated LICTI is derived from the separate LICTIs of each life member, the allocation in proportion to the separate positive LICTIs relates the amount of the SSA addition to the source of the addition (LICTI). A life member with negative or zero LICTI has not contributed in a positive manner to the consolidated LICTI and accordingly, will have no part of the consolidated LICTI allocated to its SSA.

The 1984 Blue Book states that the SSA is "an account of certain positive additions representing items that can be characterized generally as previously taxed or nontaxable amounts that would be available for distribution to shareholders..." at 595. Each company's SSA should represent that company's taxed or nontaxable amounts available for distribution to the company's shareholders. By allocating consolidated LICTI to each company in proportion to separate positive LICTI, each company is entitled to increase its SSA, and the amount available for distributions, by the proportion of the consolidated LICTI that represents the taxable income of that company.

Deduction for Dividends Received

The deduction for dividends received is an item which is determined on a consolidated basis. Sections 1.1502-11(a)(7) and 1.1502-26 of the regulations. The consolidated deduction for dividends received, ("consolidated DRD"), must be allocated to the SSAs of the members in the life/life group. Pursuant to section 1.1502-26(a), the consolidated DRD is the lesser of the aggregate of the deduction of the members of the group allowable under sections 243(a)(1), 244(a) and 245 of the Code or eighty-five percent (85%) of the consolidated taxable income computed without regard to the consolidated net operating loss deduction, consolidated section 247 deduction, consolidated DRD and any consolidated net capital loss carryback.[13]

In allocating the consolidated DRD, each life member should be credited with a share of the DRD that is proportionate to the amount of consolidated DRD generated by that life member.[14] This allocation correlates the amount of each member's share of the deduction with the source of the deduction. The source of the consolidated DRD is the separate dividends earned by the life members that qualify for the DRD. The allocation of the consolidated DRD in proportion to the individual amounts correlates the deduction to its source. The SSAs of each life member are then increased by the amount of the allotted

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[13] Section 1.1502-26(b) of the regulations states that dividends received from other members of the group are not computed pursuant to the general rule; but rather are handled in section 1.1502-14(a). This later section indicates that dividends distributed by one member to another member shall be eliminated. However, under section 818(e)(2) of the Code, if the dividends are between life members of any affiliated group, any determination with respect to such dividends shall be made as if the companies were not filing a consolidated return. Thus, the elimination of dividends between group members is not applicable for life/life members and such dividends are included in the consolidated DRD, to the same extent as other qualifying dividends.

[14] See example D, <u>infra</u>, for an application of this rule.

consolidated DRD.

Tax-Exempt Interest

The final addition to the SSAs is tax-exempt interest earned by the life members. Tax-exempt interest is not an item that is computed on a consolidated basis. Since the item is not consolidated, each member adds the amount of its own tax-exempt interest to its SSA. There is no need for any allocation since there is no consolidated amount of tax-exempt interest to be apportioned.

Taxes

Lastly, section 815(c)(2)(B) of the Code requires that the amount of the annual addition to the SSA be reduced by the amount of tax imposed under section 801 of the Code. Section 801 of the Code indicates that the tax imposed on the LICTI is computed using the tax rates specified in section 11. The amount of tax is determined on a consolidated basis[15] and thus needs to be allocated among the life members for the SSA computation. The allocation should correlate the amount of tax to the income upon which the tax is levied. The amount of the tax imposed is based on the amount of consolidated LICTI. The reduction to the SSA addition for the tax imposed should be apportioned among the SSAs of each life member in the same proportions as the allocation of consolidated LICTI among the SSAs.

The reduction to the SSAs for tax refers to the tax imposed by section 801 of the Code.[16] The reduction to the SSA addition for tax does not take into consideration any abatement in the amount of tax imposed due to tax credits, such as the foreign tax credit (section 901) or the general business credit (section 38). These credits do not modify the amount of the tax imposed by section 801. They act only to reduce the amount of imposed tax that the company is ultimately required to pay. Thus, the proper reduction to the SSAs for tax is the amount of tax imposed by section 801 of the Code without any offset by any credits which lower the amount of tax actually paid.

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[15] Regulation section 1.1502-2. See also section 1.1502-47(g) of the regulations.

[16] The flush language of section 815(c) of the Code indicates that if the tax is imposed by section 55 (alternative minimum tax) certain adjustments shall be made to the reduction to the SSA additions. In the event that the section 55 tax is imposed, the amount of the reduction to the SSA addition for taxes imposed includes the amount imposed under section 801 and section 55 of the Code.

Conclusion

In computing the proper allocation of items of addition (or reduction to an addition) to the SSAs of life members in a consolidated return, each type of addition is allocated to each member's SSA in relation to the positive source of that addition. The items which are determined on a consolidated basis and which are based on LICTI are consolidated LICTI, small and special life insurance company deductions and tax imposed by section 801; these items are allocated among the SSAs of the members in proportion to their separate positive LICTIs. The addition to SSA for the consolidated DRD is allocated among the members of the group in proportion to the amount of the DRD generated by each member. The amount of the SSA addition for tax-exempt interest is the amount of such tax-exempt interest earned by each company on a separate basis as this item is not consolidated.

Despite the computational consolidations of LICTI, DRD and taxes, once the computation has been accomplished, the allocations made and the adjustments to the SSAs completed, each life member maintains a separate SSA. By retaining separate SSAs and PSAs for each life member, at such time as a member makes a distribution, such distribution is made on a per company basis and the SSA and PSA of the company making the distribution are reduced by the amount of the distribution.

If you have any questions concerning the matters addressed herein, please call Laurie D. Lewis at FTS 566-3289.

EXAMPLES

EXAMPLE A[17]

Assume the following facts in a life/life group which includes three insurance companies L1, L2, and L3:

1. The positive tentative LICTIs are $100 (L1), $200 (L2) and $300 (L3) for a total consolidated tentative LICTI of $600;

2. The consolidated small and special life insurance company deduction for the group is $240;

3. The DRDs are $20 (L1), $60 (L2) and $40 (L3) for a total consolidated DRD of $120;

4. The amount of tax-exempt interest is $10 (L1), $5 (L2) and $50 (L3); and

5. The total tax imposed on the consolidated group $204.

The SSA of each member is adjusted as follows:

		Additions to SSAs		
	Consolidated	L1	L2	L3
LICTI	600	100	200	300
small and special	240	40	80	120
DRD	120	20	60	40
tax-exempt interest	-	10	5	50
tax imposed	(204)	(34)	(68)	(102)
TOTALS		136	277	408

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17 The amounts utilized for the small and special deductions, DRD or taxes are for illustrative purposes only and are not intended to state the actual amounts with respect to the hypothetical consolidated LICTI. The examples also do not reflect any distributions to shareholders treated as having been made out of the SSA pursuant to section 815(c)(3).

EXAMPLE B

Assume the same facts as example A, except that the LICTIs are ($200) (L1), $300 (L2) and $500 (L3), for a total consolidated tentative LICTI of $600. The SSA of each member is adjusted as follows:

		Additions to SSAs		
	Consolidated	L1	L2	L3
LICTI	600	-	225	375
small and special	240	-	90	150
DRD	120	20	60	40
tax-exempt interest	-	10	5	50
tax imposed	(204)	-	(76.50)	(127.50)
TOTALS		30	303.50	487.50

Thus, the separate gain companies L2 and L3 combined with the loss company L1 to offset some of their taxable income with L1's loss. Companies L2 and L3 together had income of $800, but were subject to tax only on $600. Without the consolidation of L1, L2 and L3, the tax on L2 and L3 would have been greater. Accordingly, by apportioning the consolidated LICTI, small and special deductions and taxes imposed between L2 and L3 in proportion to the separate positive LICTIs of L2 and L3, the SSAs of L2 and L3 are increased by the proportion of the amount of income upon which L2 and L3 were liable for tax. L1 did not have positive LICTI and did not generate any taxable income. Accordingly, L1 has no increases in its SSA for the consolidated LICTI and small and special life insurance company deductions which flow from LICTI. Company L1 did generate DRD and tax-exempt interest and was able to increase its SSA by the amount of these nontaxable items.

EXAMPLE C

Assuming the same facts as example A, except that the LICTIs are $100 (L1), $200 (L2) and ($300) (L3), for a total consolidated LICTI of $0. The consolidated life/life group of L1, L2 and L3 has no tax liability[18]. Since there is no consolidated LICTI, there are no small and special life insurance company deductions and no amount of tax imposed. The only addition to the SSAs would be for DRD or tax-exempt interest.

[18] In the event that any of the life members distributes sums from its PSA, under section 815(a)(2), the company would have tax liability with respect to the PSA distribution. Any PSA distribution would not affect the SSAs.

EXAMPLE D

Section 1.1502-26(a) of the regulations states that the consolidated DRD is the lesser of the aggregate of the deduction of the members of the group allowable under sections 243(a)(1), 244(a) and 245 of the Code or eighty-five percent (85%) of the consolidated taxable income computed without regard to the consolidated net operating loss deduction, consolidated section 247 deductions, consolidated DRD and any consolidated net capital loss carryback. For purposes of adjusting the SSA of life members under section 815, the consolidated DRD should be allocated among the companies which earned dividends which qualify for the DRD. Assume the following facts for a life/life group with four members, L1, L2, L3 and L4:

	L1	L2	L3	L4	TOTAL
separate DRD	0	30	15	50	95
separate LICTI	10	140	(75)	25	100

The consolidated DRD is the lesser of the total separate DRDs of $95 or 85% of the separate LICTIs of $100, or $85. In this example, the consolidated DRD is $85. The allocable share of the DRD is computed by dividing the separate DRD (0 for L1, 30 for L2, 15 for L3, 50 for L4) by the total DRD of 95 and multiplying this amount by the consolidated DRD of 85.

The addition to each members SSA for the consolidated DRD is as follows:

	L1	L2	L3	L4	TOTAL
share of DRD	0	26.84	13.42	44.74	85